OFFICE OF CITY CONTROLLER

CITY OF HOUSTON
INTER OFFICE CORRESPONDENCE

To	Mayor Bill White City Council Members	**From**	Rudy Garcia Deputy City Controller
		Date	July 29, 2005
		Subject	**June 2005 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending June 30, 2005.

GENERAL FUND

Total General Fund revenue projections increased by approximately $3.5 million. The increase is attributable to increases in our estimates for property taxes, miscellaneous revenues and other franchise taxes.

- The property tax revenue projection is $669.1 million, or $1.3 million more than last month. Our projection is based on year to date collections.
- We have increased our estimate for miscellaneous revenues by $1.5 million to $17.3 million. This is due to reimbursements from Reliant Energy for legal fees associated with the recent rate case.
- Our projection for other franchise fees increased by $500,000 to $16.1 million due to higher than expected cable TV receipts.

Total General Fund expenditure projections have decreased by $6.6 million. Most of this decrease, or $5.3 million, can be attributed to decreased spending at the Police Department. The remaining decrease is due to numerous true-ups at the department level.

There was also a reduction in transfers from other funds of $2 million because an anticipated transfer from Water and Sewer will not be forthcoming.

ENTERPRISE FUNDS

Aviation operating expenses have decreased by $4.5 million. The decrease resulted from lower year-to-date spending on services of $6.5 million, offset by an increase in personnel expenses of $2.1 million. A $2 million adjustment was made in other financing sources to properly recognize pension bonds receipts as liabilities rather than revenues.

Convention and Entertainment operating service expenses decreased by $622,000 and capital outlay expenses decreased by $1.1 million. These savings are the result of delays in the flood mitigation project for the parking garages.

The Combined Utility System reflects a net increase in operating revenues of $7.1 million. Water sales are up by $8.3 million over expectations due to the June drought. In addition, penalties and other revenues increased by $500,000. Offsetting these increases is a $1.7 million decline in sewer sales, which is the result of lower than anticipated demand for treated and untreated water. Operating expenses reflect a net increase of $1 million resulting from various expense true ups. Non-operating revenue and expenses increased by a net of $3.4 million. This is attributable to an increase of $1 million in interest earnings in pool investments; savings of $2.9 million in HAWC expenses at the Northeast Treatment Plant, which is still not operational; a $1.3 million decrease in other revenues due to a prior year adjustment for an electric rate correction and a decrease in CWA & TRA Contract Expenses of $800,000.

COMMERCIAL PAPER AND BONDS

The City's practice has been to maintain no more than 20% of the total outstanding debt for each type of debt in a variable rate structure. At month-end, the ratio for each type of outstanding debt was:

Type	% Variable Rate Debt	% Unhedged Variable Rate Debt
General Obligation	18.1%	5.2%
Combined Utility System	21.3%	11.0%
Airport System	22.1%	0.0%
Convention and Entertainment	27.4%	17.3%

The percentage of unhedged variable rate debt is presented for the first time. Some funds, especially Airport System, have substantial investments that will act as a hedge against the risk of increasing interest rates as higher earnings on investments offset increased debt payments on variable rate debt.

SWAP REPORT

The City's Swap Policy specifies that the City will track and report on the financial implications of its swap agreements on a quarterly basis. The report is to include a summary of key terms of the agreements, mark-to-market value, exposure to counterparties, credit ratings of counterparties or guarantors, and any collateral posted as a result of the Swap agreements. The report for June 30, 2005 is included as an attachment to this letter.

Respectfully submitted,

Rudy Garcia

Rudy Garcia
Deputy City Controller for Financial Reporting

City of Houston, Texas
Swap Agreements Disclosure
June 30, 2005

I. General Obligation Swap

On February 20, 2004 the City entered into a basis swap referred to as a synthetic reduced variance coupon swap with RFPC, LLC ("RFPC"). This swap was a negotiated transaction.

Objective. The objective of the swap is for the City to reduce its fixed rate debt service costs through a swap structure that takes on basis risk.

Terms. The City will pay a variable rate and receive a fixed rate of return on a notional principal value of $200,000,000, with the underlying bonds being various maturities of PIBS issued between 1998 and 2005. The City pays an amount equal to 5% plus the tax-exempt market standard BMA Index rate divided by .667 minus the taxable six-month US Dollar LIBOR rate minus a constant of 69 basis points, up to a maximum of 10%. The City receives a fixed rate of 5% from RFPC. Because the two 5% fixed rates offset one another, the City is effectively making payments based on BMA and receiving payments based on LIBOR plus a fixed spread. The variable rate is fixed for each budget period. The agreement is effective from March 1, 2004 to March 1, 2025. Starting in fiscal year 2017, the notional value of the swap declines as the principal amount of the associated debt is repaid in varying amounts until the debt is retired in 2023.

Receipts. Based on the initial agreement, the City received its first payment of $500,000 on March 1, 2005. After that date a payment will be received or made every six months based on the indexes for the prior budget period. The receipt on September 1, 2005 will be $297,200, resulting in a savings of 30 basis points (0.30%) on the underlying bonds. The receipt on March 1, 2006 will be $202,141 resulting in a savings of 20 basis points on the underlying bonds.

Fair value. The fair value of the swap was negative $3,405,000 as of June 30, 2005. The value was calculated using the zero coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of June 30, 2005, the City was not exposed to credit risk because the swap had a negative fair value. However, if interest rates change and the fair value of the swap becomes positive, the City will be exposed to credit risk on the swap in the amount of its fair value. RFPC has not been rated by the rating agencies. To mitigate the potential credit risk, the City required RFPC to purchase a surety bond from Ambac Assurance Corporation, a AAA rated insurance company. Ambac also insures the City's obligations under the swap. Should Ambac's rating decline in the future, RFPC will be required to post collateral for the City's benefit.

Interest rate risk. The City has an exposure to interest rate risk because it is paying a variable rate on the swap. However, this risk is mitigated because the payment formula has a BMA-based variable component that is offset by subtracting a LIBOR variable component.

Basis risk. The City is exposed to basis risk based on changes in the relationship between the taxable six-month US Dollar LIBOR index and the tax-exempt BMA index. The City entered into the swap in anticipation of savings that would be produced based on the historical trading patterns of BMA and LIBOR in different interest rate, tax, and economic environments over the past two decades. If, however, future trading patterns prove to be significantly different from historical ones, the City's anticipated savings could fail to materialize, and it could be exposed to additional costs. Among the factors that could cause this trading relationship to change would be a major reduction in marginal income tax rates, repeal of the tax-exemption for municipal bond interest, or other changes in federal policy that would reduce the benefit that municipal bonds currently enjoy in comparison to taxable investments.

Termination risk. The City may terminate the swap for any reason. RFPC may terminate the swap if both the City and the City's insurer fail to perform under the terms of the contract. If the swap has a negative fair value at the time of termination, the City will be liable to RFPC for that payment. The City's termination risk is significantly mitigated by a provision in the swap agreement that allows the City to make the termination payment in equal annual installments from time of termination up to the termination date of the agreement in 2025.

II. Combined Utility System Swaps

On June 10, 2004 the City entered into three pay-fixed, receive-variable rate swap agreements with identical rates. The City pre-qualified six firms to submit competitive bids on the swap. The bidding took place on June 7, 2004. The three firms selected all matched the lowest fixed rate bid of 3.78%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates in conjunction with the City's Combined Utility System 2004B auction rate variable interest bonds ("2004B Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt at time of issuance of the 2004B Bonds.

Terms. The notional amounts of the swap agreements total $653,325,000, the principal amount of the associated 2004B Bonds. The City's swap agreements contain scheduled reductions to outstanding notional amounts that follow anticipated payments of principal of the 2004B Bonds in varying amounts during the years 2028 to 2034.

Under the terms of the swaps, the City will pay a fixed rate of 3.78% and receive a floating rate equal to 57.6% of One-Month US Dollar LIBOR plus 37 basis points. All agreements were effective June 10, 2004, the date of issuance of the 2004B Bonds. The termination date is May 15, 2034.

Receipts and Payments. The City earned $11.52 million in swap receipts for its Combined Utility System, Series 2004B swap, and it paid $12.37 million on the underlying auction rate securities through June 30, 2005. The contractual rate for the City's swap payment is 3.78%. The average effective rate for the 2004B bonds, including payments for the Series 2004B variable rate bonds, the City's swap payments, and its dealer and auction fees, reduced by swap receipts, was 4.15%. In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds, which have a comparable maturity, was 5.08%.

Fair value. Because interest rates have changed, the swaps had a total negative fair value of $74,612,000 as of June 30, 2005. This value was calculated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of June 30, 2005, the City was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates increase and the fair value of the swap become positive, the City would be exposed to credit risk on the swap in the amount of its fair value. The City's swap policy generally requires that swap counterparties be rated double-A or better by at least one nationally recognized rating agency. As of June 30, 2005, the ratings of the three swap counterparties all met this standard (see below). Also, under the agreements, if a counterparty's credit rating falls below double-A, collateral must be posted in varying amounts depending on the credit rating and swap fair value. No collateral has been required to date.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's/S&P/Fitch)
Goldman Sachs Capital Markets Inc.	353,325,000	(40,350,000)	Aa3 /A+ /AA-
Bear Stearns Financial Products Inc.	150,000,000	(17,131,000)	Aaa / AAA / --
UBS AG	150,000,000	(17,131,000)	Aa2 /AA+ /AA+
	653,325,000	(74,612,000)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. The City has issued tax-exempt auction rate bonds with an average rate of 2.29% (not including dealer and auction agent fees) on June 30, 2005, whereas the associated LIBOR-based rate of the swap receipts at that time was 2.22%.

Termination risk. The City may terminate for any reason. A counterparty may terminate a swap if the City fails to perform under the terms of the contract. The City's on-going payment obligations under the swap (and to a limited extent, its termination payment obligations) are insured, and counterparties cannot terminate so long as the insurer does not fail to perform. If a swap should be terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.